VZCZCXRO3500
RR RUEHCN RUEHGH RUEHVC
DE RUEHHK #2170/01 3370319
ZNR UUUUU ZZH
R 020319Z DEC 08
FM AMCONSUL HONG KONG
TO RUEHC/SECSTATE WASHDC 6350
INFO RUEHOO/CHINA POSTS COLLECTIVE
RUEATRS/DEPT OF TREASURY WASHDC

UNCLAS SECTION 01 OF 03 HONG KONG 002170

SENSITIVE
SIPDIS

STATE FOR EAP/CM AND EEB/IFD/OMA; TREASURY FOR DOHNER,
WINSHIP AND CUSHMAN

E.O. 12958: N/A
TAGS: ECON EFIN HK CH
SUBJECT: HONG KONG ECONOMY FALLS INTO RECESSION; HKG
LOOKING TO CHINA FOR HELP

¶1. (U) Summary: The Hong Kong government's third quarter economic report, released November 21, confirmed that Hong Kong has officially slipped into a recession, with seasonally adjusted growth falling by 0.5 percent, after a drop of 1.4 percent in the second quarter of 2008. Private consumption held up better than expected, but merchandise trade, tourism, financial services, and private construction projects slowed sharply. Economic activity plunged in September and October, suggesting that the fourth quarter will bring an even more pronounced contraction. The Hong Kong government will increase minor government construction projects and speed up plans for large infrastructure improvements to keep construction workers busy. Officials have also announced plans to support small and medium enterprises (SMEs) by providing loan guarantees; additional SME-support proposals are reportedly on the way. Hong Kong's government and citizens increasingly are looking to China to lend a hand. End Summary.

¶2. (SBU) Comment: The HKG is determined not to repeat the mistakes of 2003, when the economy collapsed under the weight of the SARS threat. At that time, the government responded to falling revenues by cutting social spending and chopping civil service salaries, moves that further inflamed a public already angry with a slow response to the SARS crisis and its handling of proposed national security legislation. This time around, the government will use its accumulated fiscal surplus to support current levels of spending, extend subsidies, and introduce new support programs, in spite of falling revenue projections. Hong Kong citizens and the government seem increasingly willing to look to China for creative economic support, instead of searching for their own means to boost the competitiveness of Hong Kong firms. End Comment.

It's Official -- Hong Kong in Recession

¶3. (U) The Office of the Financial Secretary released the Hong Kong government's third quarter economic report on November 21. As expected, the economy continued to slow between July and September as weakening global demand hit exports of both goods and services. Real GDP growth in Q3 was 1.7 percent year-on-year, but was down 0.5 percent on a seasonally adjusted basis. This drop, on the heels of a 1.4 percent fall in Q2 (seasonally adjusted), means that Hong Kong has officially fallen into a recession.

¶4. (U) Consumption spending in Hong Kong held up surprisingly well in July and August, but dropped sharply in September. Hong Kong Government Economist Helen Chan attributed the sudden shift to the impact of bad financial news coming from the U.S. The USG takeover of Fannie Mae and Freddie Mac, the collapse of U.S. insurance giant AIG, the sale of Merrill

Lynch to Bank of America, the sale of Washington Mutual to J.P. Morgan Chase and, most importantly for Hong Kong, the failure of Lehman Bros., all within a few days, shocked Hong Kong consumers and drove Hong Kong equity valuations down 15 percent in a week. Private consumption for the quarter was up 0.2 percent year-on-year (yoy) from a high base in 2007; government consumption increased by 2.3 percent. The government's decision to waive two months of public housing rent and subsidize electricity charges helped to boost domestic demand, but early reports suggest October and November consumption numbers are well down from even September's lower mark.

=======================================
Hong Kong Trade Growth Lowest Since 2002
=======================================

¶5. (U) Hong Kong's trade account suffered in Q3 as merchandise export growth fell to its lowest level since ¶2002. Goods exports to the U.S. have been falling since Q3 2007 and this trend accelerated in Q3 2008 with exports contracting by 7.1 percent. Shipments to Japan, Korea, Singapore and Taiwan were all down. Exports to Hong Kong's largest trading partner, mainland China, grew only 3.9 percent in the quarter. This is a sharp slowdown from the double-digit growth to which Hong Kong traders have become accustomed. Service exports grew, but at a slower rate than in the past as tourist arrivals fell to their lowest level since SARS (in part due to visa restrictions imposed by PRC authorities during the Olympics) and financial services exports dropped. Citibank economist Joe Lo believes the drop in both merchandise and service exports is not fully captured

in the Q3 statistics and predicts Q4 results will be much worse.

¶6. (U) Worsening consumer sentiment also impacted investment spending during the quarter. Although spending on capital equipment and machinery increased by 9.9 percent and public construction investments increased, the fall in private construction projects pushed investment growth down to just 3 percent. The slowing economy, combined with one-off government measures and falling commodity prices, resulted in an additional drop in the Consumer Price Index from 5.7 percent to 4.6 percent. Core inflation figures, which exclude one-off government measures, also eased from 6.3 in July to 6.1 percent in September. Unofficial figures show additional easing in October to below 6 percent. Unemployment rose slightly to 3.4 percent, but accelerating layoffs across the economy are expected to push that number up quickly in the months ahead.

================================
HKG Throwing Money at the Problem
================================

¶7. (U) Against this gloomy economic news, the government is searching for policies to alleviate some of the more severe effects of the slowdown on vulnerable groups. Senior economist Helen Chan contrasted government policy moves during Hong Kong's most recent economic slowdown from 1997-2003 with proposals for the current crisis. This time, she said, the government has the resources to pursue counter-cyclical fiscal policy. The government will not cut spending, in spite of falling revenues. Current reserves will allow the government to maintain spending levels for at least two years, even if revenues slowed more than expected, according to Chan.

¶8. (U) Citibank's Lo predicted that the government will do little more than extend the current subsidies for government housing rentals and for electricity, and may provide additional support for lower income residents. Chief Executive Donald Tsang recently backed away from controversial means-testing proposals and announced modest

increases in old age subsidies (known locally as "fruit money"). The government has already extended existing loan guarantees for capital and trade financing to support local SMEs.

====================================
Waiting for a Chinese Rescue Package
====================================

¶9. (U) Over the past 30 years, Hong Kong's liberal trade policies and increasingly sophisticated financial services market have linked the fortunes of the region's economy closely to that of the United States. That link still exists, but closer economic and political relations with China have begun to erode Hong Kong's dependence on American and European markets. As recently as 1997, China absorbed just 17 percent of Hong Kong's goods exports; through the first three quarters of 2008, that figure was 48.5 percent. Together, the United States and Europe over the same period accounted for just over 26 percent of Hong Kong's goods exports.

¶10. (U) A recent survey by Hong Kong's Chinese University showed that Hong Kong citizens are increasingly likely to look to Beijing for support. Almost half agreed that the government should ask Beijing to introduce additional measures to help support Hong Kong's economy. Forty percent said the central government was best placed to facilitate the city's economic development and competitiveness, while 35 percent said the Hong Kong government and only 21 percent put their confidence in the business sector.

====================
One from Column A...
====================

¶11. (U) Chinese support for Hong Kong's economy was particularly helpful in the post-SARS period, when relaxed travel permit requirements allowed many Chinese to come to Hong Kong for tourism and shopping for the first time. Chinese President Hu Jintao and Premier Wen Jiabao have both promised support for Hong Kong's economy, including further expanding the individual visitor scheme to cover more Chinese cities. At a recent meeting on the margins of the APEC Leaders Summit in Peru, CE Tsang reportedly presented

President Hu with a list of more than 100 suggestions of ways Beijing could help Hong Kong's economy, including speeding up approvals for cross-border infrastructure projects, increasing tax concessions for Hong Kong firms operating in the mainland and expanding market access for Hong Kong service providers. One news report quoted an unnamed government source as saying, "it will be a great help to Hong Kong, even if only half of these are accepted." While these statements and requests have been prominently reported in local media, concrete support from the PRC has yet to materialize.

¶12. (U) HKMA Chief Joseph Yam has also been busily advocating for increased access for Hong Kong banks and additional RMB business in Hong Kong, including allowing RMB trade settlement in the SAR. Citibank's Lo repeated anecdotal reports that the provincial government has relaxed enforcement of recently introduced labor and environmental regulations in Guangdong, but discounted Yam's drive for additional RMB facilities in Hong Kong as unrealistic. International banks have lost too much credibility in China, said Lo. Chinese media has been warning that a Lehman Bros.'-type scandal could easily happen in China if regulations are prematurely loosened. Lo predicted that the Chinese authorities would be very cautious in approving any liberalization proposal that could reduce their control of RMB flows.
DONOVAN